

Internal Revenue Service
memorandum

CC:TL:Br3
DAMustone

date: APR 29 1988

to: District Counsel, Atlanta SE:ATL
Attn: Al Sandlin

from: Director, Tax Litigation Division CC:TL

subject: Technical Advice - [REDACTED]
[REDACTED]

It has been requested that we provide technical assistance with respect to the above case. The issue involved has been discussed with Al Sandlin of your office.

ISSUE

Whether petitioners were entitled to deduct in the [REDACTED] through [REDACTED] taxable years, contributions made to a Voluntary Employees Beneficiary Association ("VEBA") Trust at the end of each year to fund future benefits.

CONCLUSION

With respect to the accrual basis petitioners, we believe that there are substantial litigation hazards to the extent that the contributions which were actually expended by the Trust in the next year. As to the cash basis petitioners, however, the contributions plainly constitute prepaid expenses and hence, were not deductible in the year contributed.

FACTS

On [REDACTED], petitioners established an Employees Benefit (VEBA) Trust through which medical, dental, disability, life insurance, vacation pay, sick pay and holiday pay benefits for employees were to be funded. The identical benefits were provided to employees prior to the establishment of the VEBA. In addition, the medical, dental, disability, and life insurance benefits were provided through the purchase of insurance both before and after the establishment of the Trust.

Under the Trust, vacation benefits are earned on a calendar year basis and become vested on the last day of the calendar year (assuming continuous employment through the year). See VEBA Trust Document, Ex. A. The sick leave allowance is 1/2 day for each full calendar month (beginning with the date of employment); a total of six months of such leave can be accumulated. See id., Ex. B. Unused sick leave is cancelled upon termination of

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employment. See id. Lastly, holiday pay for any holiday observed by petitioners (and overtime pay in a holiday week) is generally provided to all employees. See id., Ex. C.

At the end of [REDACTED], \$ [REDACTED] was contributed to the Trust by petitioners, of which \$ [REDACTED] was properly accrued as deduction for vacation benefits under IRC § 463. See Petition, at 4; Appeals Supporting Statement, at 1, 4. At the end of [REDACTED] \$ [REDACTED] was contributed, of which \$ [REDACTED] was properly accrued under § 463. 1/ See id. And, at the end of [REDACTED], \$ [REDACTED] was contributed, of which \$ [REDACTED] was properly accrued under § 463. See id. In each year, monies were contributed not only for vacation benefits vested at the end of the particular year, but for those earned in the next year. 2/ See, e.g., Admin. file, at I-15. Moreover, it appears that the contributions at issue were not entirely expended by the Trust in the following year. For example, while \$ [REDACTED] was contributed for [REDACTED] benefits, only \$ [REDACTED] was actually dispersed for benefits and expenses in that year. See [REDACTED] Form 990, at 1 (line 17) and attached schedule III, part II.

The petitioners fully deducted the subject contributions in the year paid. In the notice of deficiency, the deductions were disallowed (except for those amounts properly accrued under § 463). The disallowed amounts were then carried over to the next year and allowed in full in that year. Two of the petitioners employ the cash method of accounting, while the other two use the accrual method. See Appeals Supporting Statement, at 4.

DISCUSSION

With respect to the accrual basis petitioners, we believe that for those amounts which were actually expended by the Trust in the next year, concession of the deduction issue is (in the event that a settlement cannot be reached) warranted. First, the

1/ It is significant that the [REDACTED] Form 990 filed by Trust shows that only a total of \$ [REDACTED] was contributed to the Trust in that year. There is no explanation in the administrative file for the discrepancy between this amount and the amount claimed as a deduction. Obviously, this discrepancy will have to be reconciled at some point in the litigation.

2/ This would appear to result in the duplication of expenses in subsequent years since the vacation pay earned in a particular year becomes vested on the last day of that year. Thus, it appears that vacation pay is being counted twice: in the year prior to when it is earned and again in the next year when it becomes vested. This discrepancy will also have to be reconciled at some point in the litigation.

litigations hazards are considerable despite the recent decision of the Supreme Court in United States v. General Dynamics Corp., 55 U.S.L.W. 4526 (April 22, 1987) respecting the "all events" test under IRC § 461(a). In our view, General Dynamics is not controlling here because unlike the medical plan involved in that case, the plan here is funded through a separate trust. And, where a welfare benefit plan is so funded, the Service has essentially taken the position that the "all events" test (which is now codified in IRC § 461(h)) is satisfied when the contribution is made to the trust. 3/ See Treas. Reg. § 1.162-10, § 1.419-1T, (Q&A-10(e)) & § 1.461(h)-4T (Q&A-1). Moreover, even though the contributions here created a reserve which had a useful life beyond the tax year involved, it will be difficult to convince a court that the entire reserve had a useful life "substantially" beyond that year as the regulations require. See Treas. Reg. § 1.419-1T (Q&A-10(b)) & § 1.461-1(a)(2). This derives primarily from the fact that most of the contributed amounts were expended by the Trust in the next year. See, e.g., Zaninovich v. Commissioner, 616 F.2d 429, 432 (9th cir. 1980) (one-year rule for capitalization).

In addition, the economic performance rules of IRC § 461(h), which are apparently applicable to the [REDACTED] and [REDACTED] taxable years, are also of no help. Thus, the regulations specify that for welfare benefits provided through a welfare benefit trust, economic performance occurs when the contribution is made to the trust. See Treas. Reg. § 1.461(h)-4T, Q&A-1. Therefore, economic performance for purposes of § 461(h) occurred here in the years in which the contributions were made. Accordingly, the requirements of § 461(h) have been satisfied in this case.

Lastly, there are practical considerations which warrant concession along the lines suggested. On December 1, 1986, the Service issued VEBA Audit Guidelines (a copy of which is attached hereto) to the field for years ending on or before December 31, 1985. Under these guidelines the subject portions of the contributions would have been presumed to be reasonable and hence, entitled to the automatic IRC § 7805(b) relief provided for under the regulations (see Treas. Reg. § 1.419-1T, Q&A-10(c)). See Guidelines, at 3-4. And, because these Guidelines are available to the public, they could be brought to the Court's attention and therefore, have an adverse impact on this case.

The cash basis petitioners, however, are a different story. In their case, we believe that there are no significant

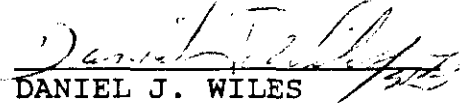
3/ And, indeed, this would appear to be the correct conclusion as a technical matter, since the payment to a welfare benefit trust, as here, plainly fixes the liability and the amount of that liability (here, the contribution made) is obviously determinable with reasonable accuracy.

litigation hazards. In general, "[a]n advance payment by a cash basis taxpayer of an item which he was not obligated to pay until a later time has been held not to be an ordinary and necessary business expense...." Bonaire Development Co. v. Commissioner, 76 T.C. 789, 795-96 (1981). Thus, the Tax Court has established that prepaid expenses are deductible only where the following requirements are met: (1) actual payment was made; (2) there was a business reason for making the prepayment in the year it was made; and (3) the payment does not cause a material distortion of the taxpayer's taxable income in the year involved. See Grynberg v. Commissioner, 83 T.C. 255, 265-267 (1984). While the first requirement has been met in this case, there is nothing to indicate that the other two have been. Therefore, it appears that the prepayments were not deductible until the year in which payment was required.

If you need any further assistance in this case, please contact David Mustone of this Division at FTS 566-3407. Copies of pertinent portions of the administrative record will be retained by Mr. Mustone.

MARLENE GROSS
Director

By:


DANIEL J. WILES
Chief, Branch No. 3
Tax Litigation Division

Attachment:
VEBA Audit Guidelines